

CLASSIFICATION OF MICRO AND SMALL ENTERPRISES

Deniss Ščulovs¹, Elīna Gaile-Sarkane²

Riga Technical University, Meža str. 1/7 – 408, LV-1048 Riga, Latvia
Email: ¹deniss.sceulovs@inbox.lv; ²elina.gaile-sarkane@rtu.lv

Abstract. Business may be viewed as the foundation of economy of any country. Business classification as provided by the European legislation cannot be directly adapted to the actual business environment in Latvia. This leads to a discrepancy between theory and practice (it is known that mostly existing theories are attributable to the large companies). Therefore, the article is devoted to classification of Latvian companies including theoretical and practical examples applied to the developed classification base. As the main conclusion, it is shown that the proposed classification is useful for both theoretical and applied objectives.

Keywords: entrepreneurship, small and medium enterprises, Latvian business environment, business regulation, classification.

Jel classification: M21, D04, D21

1. Introduction

In every country, business is regulated by a number of laws and other national or international normative documents, including European Company Law etc. According to Commercial Law of the Republic of Latvia, there are four types of businesses: self-employed, sole trader, partnership (General Partnership and Limited Partnership) and corporation (Limited Liability Company and Joint-stock company).

Companies that work utilizing the mentioned types of business can be divided into micro, small, medium and large enterprise.

Authors' research confirmed that European and Latvian Business classification, provided by European legislation cannot be directly adapted to the actual business environment in Latvia.

Objective of the paper: to describe and evaluate small and medium enterprises in Latvia and EU. To develop Latvian SMEs classification that can be useful for the business environment.

Design/methodology/approach – based on the review of scientific and practical literature, the indicators of medium and small companies are discussed. Several propositions are put forward in different for development of new approach in classification of the companies in the Baltic States and particularly in Latvia.

The goal of the paper: the authors developed classification of enterprises is applicable for various goals as confirmed by a dedicated focus group.

2. Small and medium enterprises

Small and medium-sized enterprises (SMEs) may be viewed as important players in the well-being of local and regional communities, with considerable potential for employment creation. (Kothler 2004).

Small and medium sized firms play an important role in the process of creative destruction (Acs *et.al.* 1997). Small scale enterprises worldwide have been recognized as engines of growth and development (Harper 1984).

In poor countries, you see that there are a lot of very small companies and a few very large companies and nobody in the middle. Yet we know that that middle is what carries the economy. We refer to that as the Missing Middle. (Andreas Widmer 2011).

Many people when listening to famous brands such as Coca-Cola, Heineken, Microsoft, Sony, Peugeot, Toyota, General Electric etc., that represent synonymous of advanced world, the developed economy of a country, allude to giant corporations. But, the same people agree with the fact that a small store, carwash, bakery or a restaurant at the corner of your neighbourhood represents small businesses, which are important because they provide existence for their owners and beyond (Ramadani 2011).

As such, they can play an important role in “Europe 2020” strategy, contributing to the economic health of the European economy; this numerous and disparate subpopulation of enterprises is the focus of this special feature.

In June 2008, a Communication titled *the Small Business Act (SBA) for Europe* was adopted (European Commission 2008). This recognized the central role of SMEs in the EU economy and aimed to strengthen the role played by SMEs and to promote their growth and job creating potential through alleviating a number of problems, which are thought to hamper the development of SMEs (European Commission 2010).

These included:

- alleviating administrative burdens;
- facilitating SMEs access to finance; supporting SMEs in their bid to access new markets;
- ensuring fair competition;
- promoting education skills for entrepreneurship;
- protecting intellectual property;
- encouraging research and development;
- supporting SMEs in a regional and environmental context.

This ‘mainstreaming’ of SMEs policy is based upon a premise to ‘think small first’. (Key figures on European business 2011).

Europe 2020, a strategy for jobs and smart, sustainable and inclusive growth, is based on five EU headline targets, which are:

- Employment: 75 % of the 20–64 year-olds to be employed.
- R&D/innovation: 3 % of the EU GDP (public and private combined) to be invested in R&D/innovation.
- Climate change/energy: greenhouse gas emissions by 20 % (or even by 30 %, if the conditions are right) lower than in 1990 20 % of energy from renewable 20 % increases in energy efficiency.
- Education: reducing school drop-out rates below 10 % at least 40 % of 30–34-year-olds completing third level education.
- Poverty/social exclusion: at least 20million fewer people in or at risk of poverty and social exclusion (Europe 2020 targets).

It can be concluded that the role of SMEs is growing in national economy especially in the context of global structural economic changes.

Small and medium enterprises (SMEs) are different from large organizations. These differences primarily relate to such defining SME characteristics as a reactive, fire-fighting mentality, resource limitations, informal strategies, and flexible structures (Hudson *et al.* 2001). Consequently, they tend to have a higher failure rate than that of large organizations.

The United States Small Business Administration (SBA) found that 24 % of all new businesses in the United States failed within two years and that 63 % failed within six years (Wheelen, Hun-

ger 1999). Lu and Beamish observed similar failure rates in Australia, the United Kingdom, Japan, Taiwan, and Hong Kong. Wheelen and Hunger (1999) found the high failure rate to be largely due to informal strategic planning processes and a lack of systems to keep track of the SMEs performance (Lu, Beamish 2001). SMEs in the manufacturing sector are also confronted with increased competition from cheaper manufactured products from such countries as China and India (Bessant, Tidd 2007), and are consequently struggling to develop appropriate strategies for competing with them. In light of the aforementioned SBA’s findings, it is reasonable to assume that SMEs need to formalize their structures and systems in order to become more competitive (Bessant, Tidd 2007), yet a long-running debate has been taking place in the innovation literature on the relative strengths and weaknesses of formality and informality in SMEs (Wheelen, Hunger 1999).

3. European Union SME overview

For policy purposes, SMEs in the European Union are defined as enterprises with fewer than 250 employees, provided that they are independent (of other enterprises) and do not achieve sales exceeding EUR 50 million or an annual balance sheet that exceeds EUR 43 million.

For statistical purposes, structural business statistics (SBS) may be broken down by enterprise size class according to employment thresholds:

- large (250 or more persons employed);
- medium-sized (50 to 249 persons employed);
- small (10 to 49 persons employed);
- micro (less than 10 persons employed).

Micro, small and medium-sized enterprises are collectively referred to as SMEs (Table 1). (Key figures on Europe 2011).

Table 1. SMEs structure (Source: Key figures on Europe 2011)

Enterprise category	Headcount: Annual Work Unit (AWU)	Annual Turnover	Annual balance sheet total
		or	
Medium-sized	< 250	≤ € 50 million	≤ € 43 million
Small	< 50	≤ € 10 million	≤ € 10 million
Micro	< 10	≤ € 2 million	≤ € 2 million

The overwhelming majority (99.8 %) of enterprises active within the EU-27 non-financial business economy in 2008 were SMEs – some 20.9 million – together they accounted for two out of every three jobs (66.7 %) and for 58.6 % of

value added within the non-financial business economy (Table 2).

Table 2. Enterprise size class analysis of key indicators, non-financial business economy, EU-27, 2008

(Source: Eurostat)

	Enterprises	Persons employed	Value added	Apparent labour productivity
	Share in total (%)			Relative to total (%)
All	100.0	100.0	100.	100.0
Micro	99.8	66.7	58.6	87.8
Small	92.0	29.0	21.8	75.3
Medium	1.1	17.2	18.2	105.3
Large	0.2	33.3	41.4	124.5

More than nine out of ten (92.8 %) enterprises in the EU-27 were micro enterprises; their relative share of the non-financial business economy workforce and value added was considerably lower at 29.0 % and 21.8 % (Eurostat 2011).

The number of SMEs across the EU-27 non-financial business economy was particularly concentrated within distributive trades (6.1. million enterprises). The total number of SMEs in EU- and separately in Latvia, Estonia and Lithuania are shown in the Table 3.

Table 3. Analysis of the number of enterprise size class, 2008 (Source: Eurostat)

	Total No of enterprises (thousands)	Micro	Small	Medium-sized
		%		
EU-27	20 994	92.0	6.7	1.1
LV	70	84.4	12.9	2.4
LT	139	88.7	9.2	1.9
EE	46	83.9	13.0	2.7

Statistical data (Eurostat 2011; Eurostat yearbook 2008) show, firstly, that the amount of micro-enterprises accounts for the greatest part of SMEs, secondly, that the numerical distribution among SMEs is approximately the same across the EU-27 and in the Baltic States.

Micro, small and medium-sized enterprises (SMEs) are the engine of the European economy. They are an essential source of jobs, create entrepreneurial spirit and innovation in the EU and are thus crucial for fostering competitiveness and employment (Verheugen 2011).

Analysing statistical data one can conclude that situation in the Baltic states one different from average in the EU. It might be explained by a transition from command economy to market economy over the last 20 years, specific local economic factors and local particularities. At the same time, comparison shows potential place for growth and

bring researches towards development of new theoretical and practical researches on this question.

4. Latvian entrepreneurship environment and SME overview

In Latvia too, SMEs account for a considerable part of national economy and are of great importance in contributing to the gross domestic product and employment alike.

In the mid-90s of the 20th century Latvia, a small enterprise was considered to be an enterprise corresponding to at least two of the following criteria:

- 1) value of fixed assets up to 70 000 lats;
 - 2) net turnover – up to 200 000 lats;
 - 3) average number of employees – up to 50
- (Ekonomikas skaidrojošā vārdnīca 2000).

The structure of national economy of Latvia is composed of the following groups of sectors:

- primary sectors (agriculture and forestry, fishery, extraction industry, and quarrying);
- manufacturing industry;
- electrical power, gas, water supply;
- construction;
- trade, hotels, restaurants;
- transport and communications;
- public services;
- other commercial services.

According to 2009 data of “The Economist”, 62 % of the population of Latvia were employed in the service sector (“services”), 26 % operated in industry (“industry”), and 12 % – in agriculture sectors (“agriculture”). The situation was the same also in 2008 (The Economist 2009).

The main document regulating entrepreneurial activity in the Republic of Latvia is the Commercial Law, which has been effective since 2000. The Commercial Law defines entrepreneurial activity as a commercial activity, and the entrepreneur as a merchant. The law defines commercial activity as an open economic activity, which is performed by merchants in their own name for the purposes of gaining profit. Commercial activity is one of the types of entrepreneurial activity. Economic activities are any systematic, independent activities for remuneration. A merchant is a natural person (individual merchant) or a commercial company (partnership and Capital Company) registered with the Commercial Register (Komerclikums 2000).

Hence, in effect, a merchant is an entrepreneur, who is registered with the Commercial Register and is subject to the provisions of Commercial Law, and commercial activity is entrepreneurial activity performed by a merchant (an entrepreneur registered with the Register of Enterprises)

(Nešpors 2005). Further on, the authors will employ the terms “entrepreneurial activity” and “an entrepreneur” instead of a commercial activity and a merchant, as various sources predominantly employ the former terms.

The policy of Latvian entrepreneurship, which is principally targeted at increasing entrepreneurial activities and initiative, as well as at improving competitiveness of enterprises in the European Union member states and in the majority of other countries, is considered as an intrinsic part of the economic and social policy.

It is a complex set of measures that stimulates the national economic growth and facilitates solving various social problems (uneven distribution of income, unemployment, low participatory activity of the society in country’s economic processes, etc.) (Vollman 1993).

Development of a strong and territorially balanced business sector in the country ensures that the increase in production activities does not contribute to economic and social disproportion and environmental degradation, namely, the principle of balanced and sustainable development is taken into account.

Therefore, facilitation of entrepreneurship growth corresponds to national economic policy priorities stipulated in the long-term economic strategy of Latvia:

- establishing conditions that are advantageous for functioning of the economy;
- stimulating formation of an effective and competitive structure of sectors;
- reducing socially economic disproportion and risks. (Latvijas ilgtermiņa ekonomikas stratēģijā 2008).

Experience of developed market economy countries shows that in the context of entrepreneurship policy and of its implementation, promoting development of small and medium (including micro) enterprises is specifically distinguished and emphasised.

According to the Central Statistical Bureau of Latvia (Central Statistical Bureau of Latvia, 2011) the dynamics of non-financial enterprises’ growth is positive (Table 4).

Table 4. Economically active market sector units by main kind of activity NACE Rev. (Source: Central Statistical Bureau of Latvia)

	Self-employed persons	Ind. merchants	Commercial companies	Peasant and fishermen's farms
2008	42 769	8 649	63 741	13 278
2009	45 279	8 242	63 172	11 916
2010	49 058	8 139	64 813	13 129

Data confirm that the number of SMEs remains stable from year to year, even showing positive growth. The number of micro-enterprises keeps increasing each year (self-employed persons).

The Register of Enterprises is the entity that handles registration of enterprises in the Republic of Latvia; it also gathers data on the entrepreneurship environment in the country. All enterprises dealing with entrepreneurship in the Republic of Latvia must be registered in the commercial register (Ekonomikas ministrijas mājas lapa 2011).

To understand the structure and dynamics of the entrepreneurship environment of Latvia in the context of SMEs, the authors have summarised data about SMEs (Table 5), by grouping them according to the size of enterprise (number of employed persons).

Table 5. Number of enterprises according to their size (number of employed persons) (Source: Eurostat)

Number/Year	2008	2009	2010	2011
0-9	65847	57180	58082	61790
10-49	10024	8616	8353	8579
50-249	1846	1517	1473	1513
SMEs	77717	67313	67908	71882
250+	243	199	194	203
Total	77960	67512	68102	72086

As can be seen in the above table, each year shows an increase in the number of enterprises. The greatest increase is observed in the micro-enterprise group. The authors believe that this tendency has several explanations. Firstly, to reduce the tax burden, many enterprises offer their employees to become independent micro-enterprises and then to conclude cooperation agreements with them instead of employing them as staff employees. Secondly, the Micro-enterprise Tax Law was adopted, facilitating formation of micro-enterprises and proposing a simplified taxation system. The essentials of the law are as follows:

- *micro-enterprise* – an individual merchant, an individual undertaking, a farm or fishing enterprise, as well as a natural person registered as a performer of economic activity at the State Revenue Service, or a limited liability company, which conform to the following criteria:
 - *the participants* (if any) are natural persons. The participants of a limited liability company – the natural persons – are also concurrently members of the board,
 - *the turnover* does not exceed 70 000 lats in a calendar year,
 - the number of employees does not exceed *five at any time*. Absent employees or employees

- suspended from work shall not be included in the number of employees.
- *micro-enterprise tax* – a tax, which includes:
 - a) Mandatory State social insurance contributions, personal income tax and State fee of the business risk for micro-enterprise employees,
 - b) Enterprise income tax, if the micro-enterprise conforms to the features of the enterprise income taxpayer,
 - c) Personal income tax of the micro-enterprise owner for the part of the micro-enterprise revenue from the economic activity.
 - *The micro-enterprise tax rate* shall be nine per cent.
 - A micro-enterprise is entitled to opt for payment of the micro-enterprise tax, if the income of a micro-enterprise employee from the tax-paying micro-enterprise does not exceed 500 lats per month.
 - If the income of an employee of the micro-enterprise paying the micro-enterprise tax exceeds the 500 lats, the tax shall also be applied to the part of the income earned by the micro-enterprise employee from the micro-enterprise, which exceeds 500 lats per month, applying an elevated micro-enterprise tax rate (Micro-enterprise Tax Law 2011).

The authors believe that a number of natural persons, who up to now dealt with various minor economic activities (e.g., service providers), have unofficially turned into micro-enterprises, as their partner enterprises do not request official collaboration agreements to ensure lawful collaboration.

Eurostat data show also that the majority of inhabitants of Latvia are employed in SMEs: in 2009, 447 089 people, in 2010 – 435 479, and in 2011 – 447 891 (SMEs facts 2011). This is a considerable number, taking into account the fact that according to the data of Central Statistical Bureau of Latvia, as of December 2011, 2 208 400 people live in Latvia, 1 466 908 of whom are of working age. Hence, every third Latvian inhabitant works in a small or medium enterprise.

Upon gathering information about SMEs in Latvia and EU-27, the authors conclude the following:

- entrepreneurship environment and economies of countries are based mainly on SMEs;
- the structure of entrepreneurship in all EU member states is approximately the same, employing a considerable number of EU population;
- enterprises and their employees on the one hand propose various goods and services in the global market, and on the other – they are

consumers of goods and services, forming various market segments.

- to operate productively with various market segments, an enterprise must more precisely determine and distinguish the market segments, in which it wishes to develop the targeted operations.

5. Classification of Latvian enterprises

The authors consider that the adopted EU enterprise classification is directed more at the analysis of macro-economic indicators. There is a range of spheres calling for a more elaborate distinction between enterprises, e.g., enterprises operating in the B2B sector, local governments, research agencies, marketing agencies and specialists, e-market participants, etc.

Upon performing an analysis of the theoretical background, the authors have drawn a conclusion that there is a need to employ a broader classification of SMEs for the enterprise of Latvia, in order for it to be suitable for various purposes, such as segmentation, implementation of marketing activities, development of enterprise strategy levels, activities in cyberspace, etc.

The authors are employing the axiomatic approach (Kent 2007) to forming the classification, i.e. if an enterprise meets two out of three criteria, and then it can be referred to as an enterprise of a particular size.

To verify the need of establishing new classification, the authors have performed a survey of owners and employees of micro-enterprises.

The aim of the interviews was to analyse indicators of Latvian medium and small enterprises and to find out their correspondence to real market for decision making in different levels. The period of interviews was December 2011 – January 2012. The respondent group included owners of 38 micro-enterprises and 26 small and medium enterprises. The total number of respondents was 64 in age from 24 to 63, both genders. The questionnaire for interview contained 11 questions – discussion or fill in the blank and multiple choices (for identification of the company). The interview method and total number of respondents is based on confirmed methodology developed in 1993 by Griffin, Abbie and Hauser (Ulrich, Eppinger 2008). The resume of the interviews are described below.

Results of the micro-enterprise survey:

90 % of micro-enterprise owners and employees are former employees of enterprises, who were made redundant, and then agreements were concluded with them in capacity of legal entities. 98 % of micro-enterprise employees are micro-enterprise tax payers. In 87 % of micro-enterprises,

only relatives or official partners – wives or husbands – are employed. In 70 % of micro-enterprises, 1–3 employees are working and receiving the maximum salary of 499 lats; in 20 % of enterprises, 4 employees are working and receiving 499 lats; in 10 % of micro-enterprises, 5 people are employed and receiving salary of 499 lats. More than 90 % of micro-enterprise owners have admitted that their enterprises do not have a set goal in a long-term or in a short-term, and that the only client of the enterprise is the former employer's enterprise. In all cases, the surveyed micro-enterprises had set the maximum legally stipulated salary, on which the micro-tax is imposed. 70% of micro-enterprises comprising up to 3 employees are not planning to develop or expand operations of the enterprise.

Results of survey of small and medium enterprises:

Owners of 75 % of small and medium enterprises have admitted to having implemented staff restructuring, offering their employees to become self-employed persons or micro-enterprises. Only 40 % of SMEs have developed long-term plans and goals, and have clear plans concerning future development of the enterprise. 70 % of enterprises have both natural and legal entities as clients. 65 % of enterprises analyse the market situation and competition environment. 70 % conduct client segmentation.

The authors consider that the survey results proved the need for setting up a new classification. As can be gathered from the respondents' responses, not all enterprises, especially micro-enterprises intend to operate to gain profits, but rather the aim of founding enterprises is legalising income, and the operations of such type of enterprises are represented only in macro-economic indicators, while their impact on entrepreneurship is minimum. Enterprises of this type, in the authors' opinion, are substitutes of permanent posts of staff employees.

5.1. The authors' suggested enterprises' classification

Classification is the grouping, dividing after a certain point of view (features) under certain conditions (Latviešu literārās valodas vārdnīca 1980). Classification of information it is structuring method, which aim is to group the information by certain characteristics into classes and groups (Kīns *et.al.*, 2002). The classification (Latin “clas-

sis” – the group; “klase + facere” – to do, to make) – an empirical study type; certain things or phenomena sets the allocation of classes according to the criteria, as well those criteria creation. The result of classification – a system is created. (Le-tonika 2011).

The authors' developed classification divided the companies into seven groups – individual, mini, micro, small, average, medium-sized and stable.

Companies classified according to the following characteristics or criteria set (Table 6):

- to test the established classification, a focus group was created consisting of eight representatives of various sectors and spheres:
 - entrepreneurship environment representative
 - educational sphere representative;
 - municipal organization representative;
 - marketing and advertising specialist;
 - sales specialist;
 - financial specialist;
 - consulting specialist;
 - electronic marketing specialist.

The focus group participants were engaged for one and half hour and they recognised that the authors' established classification can be applied for the following areas or sectors and groups of enterprises.

- 1) The State area: The State Revenue Service, Register of Enterprises, Latvian Statistical Office, Local governments, Development agencies, etc. (local government planning and implementation, data collection, management and controlling of the business environment, using EU structural funds etc.).
- 2) Non-governmental organisations (improving social integration, EU structural fund attraction, etc.).
- 3) Banks and insurance companies.
- 4) Science and Research.
- 5) Entrepreneurship (planning and implementing of sales and marketing activities; strategic management; B2B market segmentation and target segment (niche) definition; consumer portrait creation, positioning, consumer market research; e-marketing and e-commerce activities planning and implementation, etc.).

Table 6. Latvian enterprises classification (Source: authors of the paper)

Criteria \ Enterprise	Individual	Mini	Micro	Small	Average	Medium	Stable
Number of employed persons	1 (Self-employed)	1–3	3–5	5–20	20–50	50–100	50-250
Income per person: - limited by law, max 500 (LVL) - not limited by law	YES	YES	YES	NO	NO	NO	NO
Fixed or limited turnover per year	YES	YES	YES	NO	NO	NO	NO
Turnover per year within the boundaries (LVL)	Max 70 k	Max 70 k	Max 70 k	200 k – 1m	500 k – 2 m	2 m – 10 m	5 m – 50 m
Positive balance sheet per period (last years)	---	---	---	2	3	4	5
Affiliates or daughter companies	N/A	N/A	N/A	1 or ≥	1 or ≥	1 or ≥	1 or ≥

6. Conclusions

Research done by the authors confirmed that in small economies like in Latvia and other Baltic States, where dominating number of companies according to their size are small and micro, it is important to over evaluate offered classification of the business units.

The study results show that a large part of micro-enterprises may not be considered as entrepreneurs, because their purpose is legalising income; moreover, the amount of income is restricted. It is associated with constraints stipulated in the law governing micro-enterprise taxpayers. Therefore, this group of enterprises may not be taken into account when planning and analysing various entrepreneurship activities.

Classification of enterprises developed by the authors is applicable for various goals as confirmed by a dedicated focus group. Offered approach of classification of companies allows analysing situation in the market and plan development of national economy more precise.

The established SME classification is more applicable for performing a macro-economic analysis instead of a detailed analysis of entrepreneurship environment. Also the classification of enterprises can be a background in development of study programmes in higher education institutions and in development of a content of Life Long learning programmes due to possibility to broaden approach to topics of interest for managers.

This research can form a foundation for further researches connected to different sizes of the companies and problems of company management and value creation.

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